Office - Supreme Court, U.S.
FILED
JUN 14
ALEXANDER L. STEVAS,

No. 81-1894

In the Supreme Court of the United States

OCTOBER TERM, 1981

GRACE CAPPUCCILLI, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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In this federal income tax case, petitioners seek review of the decision below upholding the Commissioner's allocation under Section 482 of the Internal Revenue Code of interest income from Stonehedge Development Corporation to a related partnership, which resulted in an increase in each partner's distributive share of partnership income.

The relevant facts may be summarized as follows: In 1953, Peter and Rocco Cappuccilli and Gerald Paduano organized the Stonehedge Development Corporation (Stonehedge), which they owned in equal shares.[1] The three were

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[1]In 1977, Peter and Rocco Cappuccilli filed bankruptcy petitions. They are not parties to this action. The tax liabilities in dispute are those of their wives, Grace and Dorothy Cappuccilli, who filed joint income tax returns with their husbands for the years in question. The tax liabilities are based upon the business ventures of Peter and Rocco.

also equal partners in a firm called Cappuccilli, Cappuccilli and Paduano (CCP). The Cappuccillis and Paduano held their interests in the two entities until 1969 when Paduano retired from active participation in the operation of the businesses and sold all of his stock in Stonehedge to the Cappuccillis. Paduano thereafter remained a one-third partner in CCP (Pet. App. 16a-18a).

During 1961-1962, CCP acquired several contiguous parcels of undeveloped real estate, for a total consideration of $445,723. It then resold those parcels to Stonehedge in two separate sales on February 20, 1961, and December 28, 1962, for a total consideration of $1,570,327.39—including two promissory notes from Stonehedge to CCP. One note, in the principal amount of $81,000, bore interest at an annual rate of 6%. The other note, in the principal amount of $1,075,000, bore no interest. Stonehedge held the bulk of that land until 1972, but was unable to develop it as planned, due to zoning problems that could not be resolved.[2] In 1972, Stonehedge reconveyed the property to CCP in full satisfaction of the balance of the two promissory notes. During the time that Stonehedge held the land, it made some payments on the principal balance of the two notes but did not pay CCP any interest (Pet. App. 2a-5a).

On audit, the Commissioner invoked his authority under Section 482 of the Code and increased CCP's taxable income for 1967, 1968 and 1969 by a total of $325,718.90—representing applicable market rate interest on the unpaid balance of the notes. That allocation was sustained in

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[2]The Tax Court found that the original plan of the Cappuccillis and Paduano was to have CCP assemble a parcel of land suitable for development and then sell it, at a substantial profit, to Stonehedge, which would construct houses or other buildings and sell to the ultimate purchasers (Pet. App. 17a).

Paduano v. *Commissioner*, T.C. Mem. Dec. (P-H) para. 75,069 (1975), aff'd, 538 F. 2d 312 (2d Cir.), cert. denied, 425 U.S. 992 (1976). This case involves similar allocations for 1970, 1971 and 1972.[3] In addition, the Commissioner determined that the 1972 gain of $482,577 realized by CCP under Section 1038 of the Code on the reacquisition of the land from Stonehedge was taxable to the partnership as ordinary income rather than as long-term capital gain. The Tax Court upheld the Commissioner's determinations (Pet. App. 14a-45a) and the court of appeals affirmed (Pet. App. 1a-9a).

1. The decision correctly upheld the Commissioner's allocation of interest income under Section 482. Here, the device of interest free loans among related entities was used to reduce Stonehedge's losses (by the amount of interest it did not pay) and to reduce CCP's income (by the amount of interest it did not receive). This is precisely the type of manipulation of commonly controlled entities against which Section 482 is directed. See *B. Forman Co.* v. *Commissioner*, 453 F. 2d 1144, 1150-1152 (2d Cir.), cert. denied, 407 U.S. 934 (1972). See also *Kahler Corp.* v. *Commissioner*, 486 F. 2d 1 (8th Cir. 1973); *Kerry Investment Co.* v. *Commissioner*, 500 F. 2d 108 (9th Cir. 1974); *Fitzgerald Motor Co.* v. *Commissioner*, 508 F. 2d 1096 (5th Cir. 1975).

Contrary to petitioners' argument (Pet. 5-9), the decision below does not confilct with *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1973). There, the Court held that income could not be allocated under Section 482 to a company which was legally prohibited from receiving the

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[3]The Commissioner allowed Stonehedge corresponding income tax deductions for the interest income imputed to CCP.

income.[4] No such prohibition, however, is involved in this case. Had the transaction here been at arm's-length, CCP could legally have charged and Stonehedge could legally have paid interest on the loans. CCP, however, did not charge any interest to Stonehedge. *First Security Bank* is therefore distinguishable.

2. Nor does the increase in the Paduanos' taxable income violate their constitutional rights even though they were not shareholders of Stonehedge, as petitioners now contend (Pet. 11-12).[5] Gerald Paduano was a one-third partner in CCP during the years at issue. As such, he was taxable on his distributive share of the partnership's correct taxable income whether or not he received it. See *United States* v. *Basye*, 410 U.S. 441, 446-448 (1973). The allocation of interest income to CCP and then, pursuant to the rules of partnership taxation, to the individual partners, was not based on some supposed benefit the partners received as shareholders of Stonehedge. Rather, the allocation was made in order to correct distortions in income caused by non arm's-length dealings between the two commonly controlled entities, CCP and Stonehedge. Those distortions

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[4]The other cases cited by petitioners (Pet. 7), *viz.*, *Delta Life Insurance Co.* v. *United States*, 363 F. Supp. 410 (E.D. La. 1973); *Bunker* v. *Commissioner*, T.C. Mem. Dec. (P-H) para. 79,174 (1979); and *Bank of Coushatta* v. *United States*, 650 F. 2d 75 (5th Cir. 1981), do not conflict with the decision below. In *Bank of Coushatta*, the court held that insurance commissions would not be taxed to a bank which transferred its insurance sales business under a good faith belief that receipt of insurance sales commissions by the bank would be illegal. In *Delta Life Insurance Co.*, *supra*, the court simply held that the Commissioner could not, under Section 801 of the Code, require the taxpayer to carry for tax purposes a reserve smaller than that actually required by state law. These cases turn on legal constraints not present in this case. *Bunker* v. *Commissioner*, *supra*, involved an installment sale question unrelated to this case and is entirely inapposite.

[5]This issue was never raised by petitioners below (Pet. App. 9a).

exist, and the Commissioner properly invoked Section 482 to correct them, whether or not the Paduanos benefited from the distortions in income in their capacity as shareholders of Stonehedge.

3. The decision below also correctly rejected petitioners' claim that the partnership was entitled, in 1975, the year prior to Stonehedge's bankruptcy, either to a bad debt deduction or to a business loss deduction with respect to the allocated interest. Stonehedge never paid the interest. The crux of this matter is that Stonehedge never had any obligation to pay the interest. There was no debt and no loss. By failing to charge an arm's-length interest rate on loans from CCP to Stonehedge, the partners in CCP perhaps used the assets of CCP to make a contribution to Stonehedge in the amount of the interest not charged, and may be entitled to increase their bases in the Stonehedge stock to reflect this contribution. However, the transaction also reduced the income of CCP and increased the income (or reduced the losses) of Stonehedge. As the court of appeals correctly recognized, it was precisely such a shifting of income between related entities that Section 482 was intended to rectify (Pet. App. 51). Allowing petitioners an income tax deduction merely because Stonehedge did not actually pay the imputed interest to CCP[6] would serve to nullify the Commissioner's allocation (Pet. App. 61).[7]

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[6]The Tax Court found that, contrary to petitioners' claim, Stonehedge probably would have been able to pay CCP a fair rate of interest on the notes in question had it been required to do so (Pet. App. 27a-28a). The court of appeals determined that this finding was not clearly erroneous (Pet. App. 7a).

[7]Petitioners claim (Pet. 9-10) that this case involves an unconstitutional retroactive application of the Treasury Regulations under Section 482. But whether or not the Treasury Regulation under which the Commissioner made his allocation in this case is broader than the general understanding of Section 482 at the time the loans in issue were

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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JUNE 1982

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made, it is clear that Treasury Regulations may be applied retroactively. See Section 7805(b) of the Internal Revenue Code of 1954 (26 U.S.C.); *Dixon* v. *United States*, 381 U.S. 68, 71, 74-75 (1965); *Automobile Club* v. *Commissioner*, 353 U.S. 180, 184-186 (1957).

Finally, petitioners claim (Pet. 20-22) that the gain realized by CCP on the reacquisition of the land from Stonehedge should be taxed as long-term capital gain rather than ordinary income. The character of the gain taxable under Section 1038 of the Code on repossession of real property by the vendor is the same as the character of the gain realized on the original sale. Treasury Regulations on Income Tax (1954 Code), 26 C.F.R. 1.1038-1(d). The court of appeals correctly noted (Pet. App. at 7a-8a) that the gain on the original sale was taxed to CCP as ordinary income, and that the record demonstrates that the gain was in fact the "profits and losses arising from the everyday operation of a business" rather than from investments in capital assets. See *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52 (1955).

DOJ-1982-06